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SUBJECT: Consumer Product Safety in South China

BUSINESS-SENSITIVE

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¶1. (U) SUMMARY: At a time when the safety and quality of goods being exported from China -- not just to the U.S. but elsewhere in the world, from the Philippines to Europe -- has been called into question, foreign companies in this consular district, especially in the Pearl River Delta, are looking at best practices and retooling the methods they use to protect the integrity of their goods and, as importantly, their name. "Due diligence" may be an old phrase in the lexicon in the West, but in some places in China it is a new catchphrase. Companies without in-house quality control operations are increasingly depending on third-party inspectors for the certifications necessary to export their goods to the U.S. market. Insurance companies are ready, willing and able to sell liability insurance so that U.S. companies can protect themselves, but those same companies often perform but the most cursory of due diligence before issuing policies. For some insurers, like AIU, which are intent on educating the Chinese about product liability, this likely spells the beginning of a very, very lucrative market. END SUMMARY

Keeping South China Reliable -- It's all in the Details

¶2. (SBU) Although the cost of sourcing products destined for the U.S. market is generally less competitive in South China than other rural regions in the Greater China area, factories in this consular district tend to be and are considered far more reliable -- which accounts for the cost premium in the Pearl River Delta's favor. However, Jake Phipps, CEO of U.S.-based Import Agency BCD, Inc., warns against sourcing directly from a factory without first obtaining the assistance of an agent or regional representative. This is critical when doing business without a detailed contract in place, as factories will generally look to save money by altering specifications and safety standards.

¶3. (SBU) When asked how the recent wave of U.S. litigation over China product safety has changed their business practices, businesspeople in the region unanimously responded that while their approach to due diligence has not been altered, since many were already investing substantially in this up front, their insistence upon detailed specifications in supplier contracts has increased exponentially. In short, importers are increasingly looking to protect themselves by giving their suppliers little or no contractual latitude to avoid responsibility for non-compliant goods.

Third-Party Inspectors Lending a Helping Hand

¶4. (SBU) Consensus among business professionals in the region is that local third-party inspection companies (TPICs) can be relied upon only/only when dealing with low-risk product liability items.

For instance, BCD, Inc., which consults primarily on transactions involving building materials, almost exclusively relies upon Chinese TPICs to provide its inspection certificates. This practice is not without its share of risks. According to BCD's CIO, Eli Ben-Avner, in the past two years alone, the company has had three reports of inspectors being bribed by local factories to submit fraudulent or inaccurate inspection reports.

¶5. (SBU) In contrast, U.S.-based kitchen appliance importer Aroma Housewares has only received one fraudulent inspection report in its 25 years of doing business in South China. The difference probably lies in the TPICs retained by each company. Since Aroma's products are used by U.S. consumers in food preparation, the FDA regulates its imported shipments; local Chinese TPICs' certificates will not be recognized by the FDA. According to Grace Wang, Head Merchandiser for Aroma in Guangzhou, the company relies solely on certificates from internationally well regarded Swiss-based TPIC, SGS, which issues FDA-standard inspection approvals to Aroma's factory suppliers. The suppliers sell the product to Aroma, which imports it for U.S. distribution. NOTE: The cost of this process is substantially reduced when selling to other regions, such as South America, because South America does not demand FDA-equivalent standards. In this case, Aroma utilizes an entirely different production facility, and relies on local Chinese TPICs for its inspection certificates. END NOTE.

¶6. (SBU) While factory insurers do not typically require TPIC reports before issuing insurance certificates, an exception is occasionally made for electrical products. According to Simon Foo, General Manager of AIU Insurance Co. in Guangzhou, who is organizing product liability seminars for Chinese companies (and who hopes in the process to increase the amount of product liability insurance sold by AIU), this practice is due to the failure of electrical production facilities in South China to meet international UL minimum standards, as required by the U.S. and other Western

markets. Foo remains confident, however, that those products, which are eventually exported to Western markets from South China, are generally safe, particularly since UL can be tracked online to prevent the issuance of any fraudulent certificates.

Investing in Due Diligence

¶7. (SBU) Companies importing from South China appear to be investing substantially in due diligence by their suppliers. Aroma Housewares is acutely aware of the potential costs imposed when a company fails to take such measures. In 2002, the company was forced to recall over 100,000 juicers that it had imported from China, due to more than 32 reports of injuries suffered by American consumers who had purchased the faulty product. Since that time, Aroma has invested heavily in product development, employing a full-time staff of engineers whose sole responsibility is to visit the factories daily and inspect for compliance. According to Lisa Huang, Chief Representative for Aroma in China, the decision was an easy one. The added costs pale in comparison to those incurred from product-liability class action suits.

¶8. (SBU) In a similar vein, companies with a strong brand find it imperative to protect their reputation for producing quality goods. Tupperware Product Marketing Director Jonathan Cox did not appear worried about the recent China product quality scandals, noting that the company's quality control section was "anal" about quality, and that "97 percent" of Chinese factories were not up to Tupperware's standards. He also noted that Tupperware's marketing strategy was based on product quality, not price (its competitors' prices are generally one-tenth those of Tupperware), so quality control was a top priority.

¶9. (SBU) Not everyone in the region has learned this valuable lesson, but the message does appear to be getting through to most. When asked about the division of their production costs, the overwhelming majority of companies with suppliers in South China stated that a major percentage of their resources are spent ensuring product safety and specification compliance. Companies like IAS

Electronics in Shenzhen almost exclusively invest in product compliance and factory due diligence. According to an IAS China representative, to do otherwise would likely guarantee specifications short of the internationally-recognized ISO quality, and the company would be left with a warehouse full of product and no market willing to accept its distribution.

Insure or Beware

¶10. (SBU) To provide added protection, most companies sourcing products from South China are now insisting that their factory suppliers have insurance certificates, both for warranty compliance and product-liability suits. Due to reports of fraudulent certificates surfacing in the past, companies are further demanding that policies be issued by large insurance companies, such as AIU, which already have online tracking mechanisms in place to prevent any fraudulent certifications.

¶11. (SBU) Surprisingly, insurance companies, which would like to reap the windfall on liability premiums, often do not appear to be investing much in due diligence prior to issuing policies to local factories. According to Tracy Zhang, Manager of Casualty Underwriting at AIU's Guangzhou Branch, this is partly due to the insurance companies' own lack of resources. As Zhang explains, it would simply not be cost-effective to thoroughly investigate each factory before issuing insurance certificates. Instead, insurance companies in the region will typically choose to avoid issuing policies to certain "high risk" industries altogether. (See paragraph 13, below.)

¶12. (SBU) AIU's General Manager Simon Foo, nevertheless, does not rule out the possibility that the company might occasionally engage in factory due diligence prior to issuing a comprehensive insurance policy. According to Foo, the decision to do so does not depend on the product, but rather on the source of procurement. For instance, if the factory is supplying goods to a low-level importer for the U.S. market, AIU will almost never investigate the factory operations. If, however, the factory is supplying goods directly to Wal-Mart, AIU considers it mandatory to conduct a thorough background investigation before offering an insurance certificate. At times, this may even cause AIU to insist that the supplier include warning labels or certain language in its instruction manual. As Claims Department Manager Adam Yip explains, AIU will have its engineers investigate the supplier's operations, at which time the right to determine the language may either be written into the insurance contract or informally suggested to the claim holder.

Insurers Avoiding the Risky Business

¶13. (SBU) Tracy Zhang, AIU's Manager of Casualty Underwriting, told us that over 90 percent of the insurance policies issued by AIU in South China are related to products intended for the U.S. Of that 90 percent, less than one percent of the claims are eventually filed. Zhang attributes this to the company's sweeping avoidance of issuing policies to suppliers in critical industries, like auto parts, food additives, gas products, medicine and pharmaceuticals, and bicycles. According to Zhang, these suppliers are often forced to look overseas for insurance certificates, because local insurers like AIU lack investigatory resources to mitigate the risk.

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